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IRAN Strategy BRIEF

The Case for Economic Warfare

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What can the United States do about Iran?[1] Today that question, fueled by growing international concern over the Islamic Republic's persistent nuclear ambitions, has emerged at the forefront of the American strategic debate.

So far, however, serious solutions have been in distinctly short supply. Some U.S. policymakers and experts have argued in favor of engagement with the Iranian regime, claiming that a "grand bargain" will do much to alleviate Tehran's interest in "the bomb."[2] Others have maintained that Iran's atomic advances warrant immediate military action.[3] Still others insist that the United States should do nothing in response to Iran's nuclear progress, relying instead on Soviet-style deterrence to contain and counterbalance the emerging Iranian bomb.[4] Yet each of these approaches suffers from serious deficiencies, ranging from the risk of alienating Iran's young, vibrant, Westward-looking population through a diplomatic deal to the rising messianism visible within at least one segment of Iran's political elite, which greatly complicates the establishment of a stable deterrence relationship between the two countries.

In this calculus, economic measures have received comparatively short shrift. This is because conventional wisdom has it that the United States possesses little leverage that it can bring to bear in order to deter and contain Iran's nuclear ambitions. In this case, however, the conventional wisdom is wrong; the United States has a considerable number of economic tools at its disposal, despite its lack of trade relations with the Islamic Republic. America's allies and trading partners, who, almost without exception, maintain extensive economic ties to the Islamic Republic, possess much more. Rather, what has been missing so far has been a coordinated strategy that exploits the latent vulnerabilities within the Iranian economy. These include:

GASOLINE DEPENDENCY

Despite its massive oil production (some 3.8 million barrels daily), Iran is a voracious consumer of foreign refined petroleum, importing approximately 40 percent of its total annual gasoline consumption from abroad. Between March 2006 and March 2007 (Iranian calendar year 1385), it spent some $4.2 billion on gasoline purchases from sixteen countries: the United Arab Emirates (UAE), India, the Netherlands, France, Singapore,

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Turkmenistan, Azerbaijan, Sudan, Belarus, Turkey, Kuwait, Taiwan, Spain, Sweden, Saudi Arabia, and Bulgaria.[5] These deliveries were not surplus; the Iranian regime currently lacks a substantial domestic strategic petroleum reserve, maintaining just 45 days worth of gasoline inside the country.[6] And without one, even a partial cutoff of supplies would leave Tehran with just two options: to hike prices, or to limit consumption.

ECONOMIC HIERARCHY

Today, the vast majority of wealth in the Islamic Republic is concentrated in the hands of a small group of people, whose associates and relatives dominate the Iranian economy. The most public of these is the extended family of former Iranian president (and current Assembly of Experts head) Ali Akbar Hashemi Rafsanjani, which now virtually controls copper mining in Iran, the regime's lucrative pistachio trade, and a number of profitable industrial and export-import businesses.[7] A related economic power center is Iran's *bonyads*, the sprawling, largely-unregulated religious/social foundations overseen by Iran's Supreme Leader. The sums controlled by these organs are enormous, estimated at more than 30 percent of Iran's national GDP (and as much as two-thirds of the country's non-oil GDP).[8] Likewise, Iran's powerful clerical army, the *Pasdaran* or Islamic Revolution Guard Corps (IRGC), is a major, and growing, economic force within the Islamic Republic, in command of numerous construction, industrial, transportation and energy projects, as well as various commercial enterprises valued in the billions of dollars.[9] Given this centralized economic hierarchy, targeted financial measures that restrict the ability of those "super-empowered" individuals and organizations to access international markets—and curtail their capacity to engage in commerce—are likely to have an immediate and pronounced effect on regime decision-making.

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FOREIGN DIRECT INVESTMENT

Since the start of the War on Terror, Iran's economic fortunes have experienced a dramatic reversal. During the late 1990s, plummeting world oil prices left the Iranian regime virtually bankrupt. Today, however, the energy-rich nation is reaping an unprecedented economic windfall as a result of global political instability. As of March 2006 (the end of Iranian calendar year 1384), officials in Tehran publicly estimated their country's hard currency reserves at some $50 billion.[10] Yet all of this does little to diminish Iran's need for foreign direct investment. According to authoritative estimates, Iran's energy sector still requires some $1 billion annually to maintain current production levels, and $1.5 billion a year to increase this capacity.[11] Without such sustained capital, it is believed that Iran could revert from an energy powerhouse to a net energy importer in the span of very few years.[12] While it is impossible to completely cut the Iranian regime off from international commerce, measures that target foreign investment and technology transfers into Iran can slow the Islamic Republic's nuclear progress, complicate its access to

1. This article is adapted from testimony by the author before the Subcommittee on the Middle East and South Asia, Committee on Foreign Affairs, U.S. House of Representatives, October 23, 2007.

2. See, for example, Flynt Leverett, "All or Nothing: The Case for a U.S.-Iranian 'Grand Bargain,'" testimony before the Subcommittee on National Security and Foreign Affairs, Committee on Oversight and Government Reform, U.S. House of Representatives, November 7, 2007.

3. See, for example, Norman Podhoretz, "The Case For Bombing Iran," *Commentary*, June 2007.

4. See, for example, Barry R. Posen, "We Can Live with a Nuclear Iran," *New York Times*, February 27, 2006.

5. "Iran Imported Gasoline From 16 States in 2006," Mehr (Tehran), May 20, 2007.

6. Study by Iran's Institute for International Energy Studies, as cited in Ali Nourizadeh, "Exploring Iran's Military Options," *Al-Sharq al-Awsat* (London), January 23, 2006.

7. Paul Klebnikov, "Millionaire Mullahs." *Forbes*, July 21, 2003.

8. Ibid.; See also Kenneth Katzman, Statement before the Joint Economic Committee of the United States Congress, July 25, 2006.

9. Mehdi Khalaji, "Iran's Revolutionary Guard Corps, Inc.," Washington Institute for Near East Policy *Policywatch* no. 1273, August 17, 2007.

10. *Aftab-e Yazd* (Tehran), May 10, 2006, as translated in *Mideastwire Daily Briefing*, May 12, 2006.

11. "NIOC Undertaking Host of Projects to Boost Oil Output," *Middle East Economic Survey* XLVIII, no. 19 (2005), as cited in A.F. Alhajji, "Will Iran's Nuclear Standoff Cause a World Energy Crisis? (Part 1 of 2)," *Middle East Economic Survey* XLIX, no. 13 (2006).

12. Kenneth Katzman, *The*

foreign funding, and/or force depletion of the hard currency reserves amassed over the past several years.

TRADE RELATIONSHIPS

Today, Iran boasts a combined total foreign trade of nearly $100 billion annually.[13] The regime's largest trading partners are the European Union, Japan and the United Arab Emirates, which cumulatively account for over half of Iran's total global imports and exports each year.[14] Germany alone accounts for more than Euro 4 billion ($5.45 billion) in trade with the Islamic Republic.[15] The Iranian regime, moreover, is actively working to expand these economic relations, and to establish new ones (particularly with the countries of the "post-Soviet space"). These ties, however, are as much a liability as they are an asset, since the vast majority of Iran's trading partners boast far more extensive economic ties with the United States. In 2004-2005, for example, Japan's annual two-way trade with Iran totaled some $3.7 billion a year, while its commerce with the United States was nearly *fifty times* that: $180 billion annually.[16] If forced to chose, therefore, Iran's trading partners will inevitably prioritize their commercial relationship with the United States over keeping the current regime in Tehran in business.

As of yet, the United States has been slow to exploit these "points of entry" into the Iranian economy. Rather, for the past several years, the Bush administration's approach has centered on a slow-moving diplomatic effort to coerce Iran into abandoning its nuclear ambitions via the United Nations. This track has tallied some modest results; last December, the United Nations Security Council passed Resolution 1737, imposing sanctions on a number of known WMD suppliers to the Iranian regime, and setting the stage for additional financial measures if the Iranian regime continued its nuclear defiance.[17] Four months later, in March of this year, the Security Council adopted Resolution 1747, which widened the scope of previous sanctions and imposed an embargo on weapons-related trade going into and out of the Islamic Republic.[18]

Since then, however, it has become clear that the UN track is moribund. Despite continued Iranian intransigence and months of deliberations, the P5+1 (the United States, Great Britain, Russia, China, France and Germany) have been unable to reach consensus on supplemental sanctions against the Iranian regime. And without coordinated action from the international community, Iran has gained valuable time to add permanence to its nuclear effort.

Increasingly, this deadlock has prompted the United States to pursue an ancillary, unilateral effort to force companies and financial institutions to end or scale back their ties with the Islamic Republic. This drive, spearheaded by the U.S. Treasury Department's Office of Financial Intelligence, has had some impact. As of this writing, three of Iran's six state-owned banks—Bank Sadarat, Bank Sepah and Bank Melli—have been blacklisted from the U.S. financial system,[19] and more such designations may materialize. As a direct result, a number of foreign companies and banks (among them Germany's Deutche Bank and Commerzbank, as well as Switzerland's UBS and Credit Suisse) have given notice that they plan to scale back, if not sever outright, their financial dealings with the Iranian regime.[20]

Most recently, the Bush administration has enacted new financial measures severing the IRGC from the U.S. financial system.[21] The designation, made in October by the Department of State, also bars a number of IRGC-linked companies and individuals from trading in the U.S. market, either directly or potentially by proxy. All told, more than 20 entities connected to the regime's clerical army—including its premier paramilitary unit, the Quds Force—have been targeted by the new sanctions.

It is clear, however, that much more can still be done.

Iran-Libya Sanctions Act (ILSA) **(Washington: Congressional Research Service, July 21, 2003), 2; See also "Iran: U.S. expert predicts oil-export crisis within a decade,"** ***Radio Free Europe*****, January 12, 2007.**

13. Extrapolated from "Country Profile: Iran, Islamic Rep. of," World Trade Organization, April 2007.

14. Ibid.

15. Ralf Beste, Christoph Pauly and Christian Reiermann, "US Pressures Germany to Cut Iran Business Ties," ***Der Spiegel*** **(Hamburg), July 30, 2007.**

16. "Islamic Republic of Iran—Statistical Appendix," International Monetary Fund Country Report no. 04/307, September 2004; Assistant U.S. Trade Representative for Japan, Korea and Asia-Pacific Economic Cooperation Affairs Wendy Cutler, testimony before the Ways and Means Committee of the U.S. House of Representatives, September 28, 2005.

17. United Nations Security Council, S/res/1737 (2006), December 27, 2006.

18. United Nations Security Council, S/res/1747 (2007), March 24, 2007.

19. News release, "Treasury Cuts Iran's Bank Saderat Off from U.S. Financial System," U.S. Department of the Treasury, Office of Terrorism and Financial Intelligence, September 8, 2006; News release, "Iran's Bank Sepah Designated by Treasury, Sepah Facilitating Iran's Weapons Program," U.S. Department of the Treasury, Office of Terrorism and Financial Intelligence, January 9, 2007; "Fact Sheet: Designation of Iranian Entities and Individuals for Proliferation Activities and Support for Terrorism," U.S. Department of the Treasury, October 25, 2007.

20. "Iran: Top U.S. Official Says Financial Clampdown Is Working," ***Radio Free Europe/ Radio Liberty*****, October 17, 2007; See also Patrick Clawson and Michael Jacobson,**

“How Europe Can Pressure Iran,” *Wall Street Journal Europe*, November 2, 2007.

21. “Fact Sheet: Designation of Iranian Entities and Individuals for Proliferation Activities and Support for Terrorism.”

22. See, for example, “Iran Bans Negative Petrol Stories,” BBC (London), June 28, 2007.

23. “Iran Cuts Petrol Imports to Save Nearly $3 Bln,” Fars (Tehran), September 26, 2007.

24. “Iran Faces a Gasoline Time Bomb,” *Petroleum Intelligence Weekly* 45, iss. 38 (2006), 4.

25. Iran and Libya Sanctions Act of 1996, Public Law 104-172, August 5, 1996.

26. Eli Lake, “Russian Oil Divestiture Sends Signal to Iran,” *New York Sun*, October 23, 2007.

27. Michael Barone, “Divest Iran,” RealClearPolitics, August 27, 2007.

IMPOSING A GASOLINE EMBARGO

The Achilles’ Heel of the Iranian regime is the intersection of its inefficient centrally-planned economy and its deep dependence on foreign refined petroleum. Notably, the Iranian regime is acutely aware of this vulnerability, and actively attempting to eliminate it. This past June, the Islamic Republic enacted a rationing plan establishing strict monthly quotas on gasoline for ordinary Iranians.[22] It likewise has attempted to institute steep cuts to its petrol purchases from abroad.[23] And regime officials have launched a major effort to ramp up domestic refining capacity, commissioning upgrades to existing refining facilities and the construction of new plants (although these added capabilities are not expected to come online until the end of the decade at the earliest).[24] Yet, even with these countermoves, a partial cut-off of gasoline by its suppliers would force the Iranian regime to either ratchet up prices or impose further gasoline rationing—both of which could dramatically and negatively affect regime stability. The United States should work with its allies to pressure Iran’s petroleum suppliers in order to test that proposition.

ACTIVATING UNILATERAL SANCTIONS

When it passed the Iran-Libya Sanctions Act (ILSA) in 1996, Congress had a clear goal in mind: to curb Tehran’s capacity to acquire weapons of mass destruction and support international terrorism by forcing foreign companies and governments to scale back their economic involvement with the Iranian regime.[25] Over the past decade, however, this commitment has been honored entirely in the breach. Successive U.S. governments—irrespective of political affiliation—have consistently prioritized bilateral trade over international security, waiving application of ILSA and other relevant punitive measures. Today, such inaction is no longer an option. The goal of American policy should be to compel the aggressive implementation of both existing legislation and new laws (such as the 2007 Iran Sanctions Enhancement Act) designed to convince foreign nations that they can trade with the United States, or with Iran, but not with both.

There is ample evidence that such pressure can work. In October, for example, Russia’s second largest oil company, Lukoil, announced that it was suspending development work on Iran’s massive Anaran oil field. The reason cited? Fear of American sanctions. “We opened the largest field in Iran, but we can’t work there because the U.S. State Department has banned third countries from investing more than $20 million,” Lukoil’s vice president, Leonid Fedun, told reporters in Moscow by way of explanation.[26] Lukoil’s decision suggests that, for all of their public bluster in support of the regime in Tehran, policymakers in Moscow are acutely aware of the potential costs of their continued partnership with the Islamic Republic—and are taking active steps to mitigate risk.

HARNESSING DIVESTMENT

Government efforts to compel companies and financial institutions to scale back their investment in the Islamic Republic have been replicated at the state and local level. “Divestment” has made significant strides since its start some two years ago; several U.S. states—among them Missouri, Florida and California—have already passed laws prohibiting their pension funds and state-owned enterprises from investing in Iran, and a number of others (including Pennsylvania, New York, Michigan, Massachusetts, and Georgia) currently have similar legislation pending or in the works.[27] And with dozens of billions of dollars in U.S. funds still invested in companies that trade with Iran, this effort can have great utility in reducing the Islamic Republic’s economic influence.

In order to be effective, however, divestment must be harnessed by the Executive Branch as part of a comprehensive effort to economically isolate the Iranian regime. Currently, the opposite is true: divestment is gathering steam not because of robust Administration action, but because of its absence. The White House's response to this effort, meanwhile, has been less than constructive; Administration officials have made no secret of their displeasure with the various divestment bills now wending their way through state legislatures around the country and, operating by proxy, the White House has so far succeeded in stymieing Congressional efforts to give these state laws greater potency.[28] All of this is deeply counterintuitive, since divestment can serve as an important complement to existing Administration approaches. While the private sector can only offer "sticks" to foreign countries and companies, the federal government can reward cooperation in divestment campaigns with preferential trade sweeteners. To that end, the White House must move quickly and resolutely to adopt divestment measures as an adjunct to its other economic policies vis-à-vis Iran.

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Admittedly, such steps are not likely to be cost-free. Detractors maintain that economic pressure against Iran could have a number of adverse consequences, ranging from added hardship for ordinary Iranians to a unifying domestic effect that strengthens the current regime to Iranian retaliation against global energy supplies. Indeed, all of these are real risks. Nevertheless, short of military force, serious economic measures represent the most effective way for the West to respond to the Islamic Republic's nuclear efforts—and, as a practical matter, to complicate Tehran's path toward "the bomb."

The time available to do so, however, is running out. Back in February, Director of National Intelligence Mike McConnell told the Senate Armed Services Committee that the U.S. intelligence community estimated that Iran could field a nuclear weapon by "early to mid next decade."[29] New evidence, however, suggests that the Islamic Republic may be much closer to an atomic capability than originally thought. In October, officials in Paris revealed to reporters that they believed Iran would have nearly 3,000 uranium enrichment centrifuges running by the end of that month. They based their assessments on analysis provided by the UN's atomic watchdog, the International Atomic Energy Agency, which stated that the Iranian regime was expected to have 18 separate centrifuge cascades—totaling nearly 3,000 centrifuges in all—operational by late October.[30] (Just weeks later, Iranian officials appeared to confirm this estimate when they announced that they had begun operating the requisite 3,000 centrifuges at the regime's uranium enrichment facility in Natanz.[31])

The finding is significant, and ominous. Nuclear experts say that 3,000 centrifuges represent a key atomic threshold. With that number of centrifuges spinning continuously for one year, a nation can generate enough highly-enriched uranium for one nuclear weapon. Based on these projections, and barring any technical glitches or other unforeseen eventualities, Iran could be able to produce enough fissile material for a nuclear weapon by sometime during the Fall of 2008.

Soon, therefore, the United States and its allies will be faced with just two options: to allow the Islamic Republic to cross the

28. See, for example, Shmuel Rosner, "Bush Administration Opposes Bills on Divestment From Iran, Sudan," *Ha'aretz* (Tel Aviv), August 29, 2007; Author's conversations with Congressional staff, Washington, DC, October 2007.

29. Director of National Intelligence John M. McConnell, "Annual Threat Assessment," statement before the Senate Armed Services Committee, February 27, 2007.

30. "French Officials: Iran Set to Run Nearly 3,000 Uranium-Enriching Centrifuges by Late October," Associated Press, October 3, 2007.

31. Ali Akbar Dareini, "Iran: 3,000 Centrifuges Fully Working," Associated Press, November 7, 2007.

nuclear threshold, or to use force to prevent it from doing so. If they hope to avoid such a fateful decision, policymakers in Washington need to implement a serious economic warfare strategy that leverages Iran's latent vulnerabilities as a way to convince Tehran that the tangible costs of moving forward with its nuclear program far outweigh the perceived benefits of atomic acquisition.

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